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Tax Free Exchanges of Real Property Under Section 1031 of The Internal Revenue Code of 1954†

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I. Introduction

A. *Description of Section 1031 as It Affects Real Property Exchanges*[1]

Section 1002 of the Internal Revenue Code of 1954 provides, "Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of gain or loss, determined under section 1001, shall be recognized." Section 1001(a) of the Code provides that the gain or loss to be recognized is the difference between the amount realized on the disposition of the property and the adjusted basis of the property at the time of the disposition. The amount realized is defined in section 1001(b) as the sum of any money received plus the fair market value of property other than money received. Section 1031 is one of the several exceptions to these rules.

In an exchange to which section 1031(a) is applicable, recognition of gain or loss is deferred until the property is transferred in a subsequent taxable exchange. The property acquired assumes the basis of the property transferred. The purpose of the provision

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1. Throughout this Article certain words and phrases are used the meaning of which may not be readily apparent. In this regard, the following words and phrases have the following meanings:

Code—The word Code is used as a shortened reference for the Internal Revenue Code of 1954. To the extent reference is intended to any other Code, that reference will be specific.

Section—The word section is used as a shortened reference to a section of the Internal Revenue Code of 1954. To the extent the reference is to a section in another Code, that reference will be specific.

Service—The word Service is used as a shortened reference to the Internal Revenue Service.

Qualified Property—The phrase qualified property refers to the certain described property which under section 1031(a) of the Code may be transferred without the recognition of gain.

Unqualified Property—The phrase unqualified property has reference to that certain property which may not be transferred under section 1031(a) without the recognition of gain. In any particular instance, it may refer to property qualified by definition but not transferred or received for like-kind property. The word boot, normally used to refer to unqualified property in a tax-free exchange, is not used in this Article. The word boot normally includes money in its reference and money is given a different tax treatment than other unqualified property in section 1031 transfers. To avoid confusion, this Article refers to unqualified property and/or money as is appropriate.

Like-Kind—The phrase like-kind is used to refer to that property or the exchange of that property which qualifies, under the definition of section 1031(a), as like-kind property.

Exchange Property—The phrase exchange property refers to property acquired, utilized or to be utilized in a section 1031(a) exchange.

Nonrecognition Exchange—An exchange in which no gain or loss realized is recognized for tax purposes.

is to save a taxpayer from immediate recognition of gain and to intermit the claim of a loss in exchange transactions where a gain or loss may have occurred in a bookkeeping or accounting sense but in a practical and economic sense the gain or loss was a mere paper transaction.[2]

The taxpayer with substantial real estate assets may find the section 1031 exception to the general rule a useful tax-planning procedure or a frustrating trap. In many instances a section 1031 exchange may be the only practical method of extracting a taxpayer's investment from an asset that is no longer a useful or desirable part of his investment portfolio. Real estate is typically an investment that is held for long periods of time and has an enormous propensity to appreciate in value. In some instances, because of the fortunes of location and community development, the appreciation in value is rapid and substantial. While the owner is pleased with his increased fortune, he may find himself in a classic real estate lock-in situation. His basis may be so low, relative to the market value of his property, that a taxable sale may not be practical.

Even if the tax burden were not the controlling consideration, an exchange under section 1031 may be useful. Thus, taxpayers who wish merely to change the form of their real estate investment, rather than to liquidate their holdings, should certainly consider a tax-free exchange under section 1031. This group of taxpayers would include both individuals near retirement who want to change from passive investments to property that will provide an income after retirement and high income taxpayers who seek to change their investments from income producing to passive. Income considerations aside, a taxpayer simply may want to relocate. A farmer may find urbanization crowding his farm operation or increasing his real estate taxes to an impractical level, or a taxpayer may want to move from one part of the country to another or even to a foreign country. In all of these situations, an exchange under section 1031 may permit the taxpayer to accomplish his objectives without a needless tax erosion of his investment.

While section 1031 can frequently be used to advantage, its application to a transfer is not always advantageous or desirable. In some instances, it may be appropriate to effect a taxable transaction. Thus a taxpayer may wish to sell real estate in a taxable transaction in order to take advantage of a loss for tax purposes. Another often encountered example is the taxpayer who seeks a taxable transaction in order to increase his depreciable basis in newly acquired property. If either of these results are desirable, qualification of the transaction under section 1031 should be avoided. If the transaction qualifies as a section 1031 exchange,

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2. Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1945).

the recognition of loss will not be allowed and the basis of the transferred property will be carried over to the newly acquired property. Basis will only be increased if taxable, non-qualifying property is included in the exchange.

The trap for the unwary in these situations is that the application of section 1031 to a transaction is not elective. If the transaction meets the requirements of section 1031, the nonrecognition rules will be applicable. The intent of the parties or the labels they have given the arrangement will not serve to avoid the nonrecognition result.

B. *Brief History of the Development of Section 1031*

An understanding of the application of the various provisions of section 1031 to transactions of the type mentioned above may be facilitated by a brief review of the origin and development of the section.

Prior to the Revenue Act of 1921,[3] there were no provisions for the nonrecognition of gain or loss when one property was exchanged for another. The Revenue Act of 1918 provided that in determining gain or loss when property was exchanged for other property, the property received in the exchange was treated as the equivalent of cash to the extent of its fair market value.[4] Under this Act every exchange of property had potential tax significance for a taxpayer with impact depending upon the market value of the property involved. The difficulty of administering a tax based upon such an uncertain value prompted Congress to deal specifically with the problem in the 1921 Act.[5]

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3. Revenue Act of 1921, ch. 136, 42 Stat. 227, 1939-1 (Pt. 2) C.B. 175.
4. Revenue Act of 1918, ch. 18, § 18, 40 Stat. 1057.
5. The House of Representatives' report accompanying the 1921 Act, in referring to the rules under the Revenue Act of 1918 for recognizing gain or loss in property exchanges, provides in part:

> Probably no part of the present income tax law has been more productive of so much uncertainty and litigation or has more seriously interfered with those business readjustments which are peculiarly necessary under existing conditions. Under existing law the presumption is in favor of taxation. The proposed bill modifies that presumption by providing that on an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a definite and readily realizable market value; and specifies in addition certain classes of exchange on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value.
>
> The preceding amendments, if adopted, will, by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious

Under the 1921 Act, there was to be no taxation unless the property received in exchange had a *readily realizable* market value. In certain classes of exchanges, no gain or loss was to be recognized even if the property received in exchange had a readily realizable market value. Section 202 of the 1921 Act identified these particular exchanges as the exchange of property held for investment or for productive use in a trade or business (excluding stock in trade or property held primarily for sale) for property of a like-kind or use; certain exchanges incident to a corporate reorganization; and transfers of property to a corporation if immediately after the transfer the taxpayer or taxpayers were in control of the corporation.[6] Section 202(d) provided that in those exchanges under section 202(c) where no gain or loss was recognized, the property received would be treated as taking the place of property exchanged therefore.[7] Section 202(e) of the 1921 Act provided an exception to the general rule of section 202(c). If, in addition to property with no readily realizable market value, money or property which had a readily realizable market value was exchanged, the money or fair market value of the property with the readily realizable market value was first applied against the basis of the property exchanged, with any excess over basis taxable.[8]

A very significant change in this statutory scheme was effected by amendment in 1923.[9] The Treasury Department report on the proposed legislation indicated a serious problem with securities exchanges effected in such a manner as to avoid recognition of gain. Thus, where securities had appreciated in value, the taxpayers avoided recognition of gain by exchanging the stock for other securities plus cash but, where the securities had declined in value they were sold for cash and loss deducted from income. In order to close this loophole, that part of section 202(c) of the 1921 Revenue Act[10] which provided that in an otherwise tax-free exchange, gain would be recognized to the extent money or the fair market value of other unqualified property received exceeded the basis of the property exchanged was amended. The amended language provided that, in these exchanges, gain would be recognized, but not in excess of the money or fair market value of the other unqualified property received.[11] Any unqualifying property not

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exchanges. Proper safeguards are found . . . which provide that where property is exchanged for other property and no gain or loss is recognized, the property received shall be treated as taking the place of the property exchanged, for the purpose of determining gain or loss and for the purpose of determining certain important deductions, such as those for depreciation.

H.R. Rep. No. 350, 67th Cong., 1st Sess., 1939-1 (Pt. 2) C.B. 168, 175.

6. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230.
7. *Id.* at (d).
8. *Id.* at (e).
9. H.R. Rep. No. 1432, 67th Cong., 4th Sess., 1939-1 (Pt. 2) C.B. 845.
10. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230.
11. H.R. Rep. No. 1432, 67th Cong., 4th Sess., 1939-1 (Pt. 2) C.B. 845.

taxed as gain under this section was applied against and reduced basis. However, the House of Representatives' report accompanying the bill also made it clear that it was not desirable to tax unrealized profits:

> [T]he profit, so far as it is contained in the new stock received, has not yet been realized, and therefore should not be taxed until the new stock is sold or in some way disposed of so that the profit will be actually realized.[12]

It soon became quite apparent that administering a tax based upon whether a property had a "readily realizable market value" was no less difficult than determining the market value itself. As far as the Treasury Department was concerned, practically every property had a "readily realizable market value." The limitation was rarely applied by the Internal Revenue Service and a tax-free exchange was rarely accomplished without litigation.[13] Consequently, the exchange provisions were extensively rewritten in the Revenue Act of 1924[14] to substantially the same form as the present version of section 1031.

Congress did not again direct its attention to the exchange provisions of the Code in a major revenue act or otherwise significantly discuss them until the Revenue Act of 1934.[15] Even then, its concern was only in passing and no changes were made in the provisions.[16] For the most part, the exchange provisions, as they existed

12. *Id.* at 847.

13. S. Rep. No. 398, 68th Cong., 1st Sess., 1939-1 (Pt. 2) C.B. 266, 275.

14. Revenue Act of 1924, ch. 234, § 203, 43 Stat. 253, 256, 1939-1 (Pt. 2) C.B. 241. In referring to the language of the 1921 Act, the House of Representatives' report accompanying the Revenue Act of 1924 in discussing the necessity for revision of the section stated in part:

> The provision is so indefinite that it can not be applied with accuracy, nor with consistency. It appears best to provide generally that gain or loss is recognized from all exchanges and then except specifically and in definite terms those cases of exchange in which it is not desired to tax gain or allow the loss.

H.R. Rep. No. 179, 68th Cong., 1st Sess., 1939-1 (Pt. 2) C.B. 241, 251.

15. Revenue Act of 1934, ch. 277, § 112, 48 Stat. 680, 704.

16. The House of Representatives' report accompanying the Act seemed to reflect the position that the provisions were inconsequential. After noting that the Treasury Department felt that the exchange provisions did not in fact result in tax avoidance, the report states that the potential revenue increase that may result from taxing all exchange transactions would not justify the additional administrative expenses involved. However, the report does contain a brief statement of the congressional understanding of the impact of the exchange provisions which should be noted:

> In other words, profit or loss is recognized in the case of exchanges of notes or securities which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he

in 1934, were carried into the Revenue Act of 1954[17] without significant change. Not surprisingly, then, many of the difficulties and uncertainties found in the earlier statutes continue to present problems under section 1031 of the Code today. Nevertheless, as real estate continues to appreciate at ever accelerating rates, the use of the section 1031 exchange as a tax planning device has attracted serious attention and is the topic on which the balance of this article will focus.

II. Basic Statutory Scheme of Section 1031

Subsection 1031(a) of the Code provides:

> No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest or other securities or evidences of indebtedness of interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.[18]

Subsection 1031(b) provides that if, in addition to the property described in 1031(a), an exchange includes other property or money, ". . . then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."[19]

Subsection 1031(c)[20] provides that if an exchange would be within the provisions of subsection (a) except for the receipt of unqualified property, no loss from the exchange may be recognized.

Subsection 1031(d) sets forth three basic rules for determining the basis of property involved in an exchange: (1) if property is acquired in a 1031 exchange, the basis is to be the same as that of the property exchanged, decreased in the amount of any money received and increased in the amount of gain or decreased in the amount of loss recognized; (2) if unqualified property other than money is received in the exchange, basis must be allocated among the properties in an amount based upon fair market value on the date of the exchange; and (3) any liability transferred or assumed by the other party to the exchange, as part of the exchange, is to be considered money received by the taxpayer.

Subsection 1031(e) concerns livestock exchanges and will not be discussed in this article.

> is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.

H.R. Rep. No. 704, 73d Cong., 2d Sess., 1939-1 (Pt. 2) C.B. 554, 564.

17. Int. Rev. Code of 1954, § 1031.

18. *Id.*

19. *Id.* at (b).

20. *Id.* at (d).

A. *Nonrecognition of Gain or Loss from Exchanges Solely in Kind: Section 1031(a)*

1. *Definition of Property for Purposes of Section 1031(a)*

The nonrecognition provisions of section 1031(a) are applicable only to certain types of property which are exchanged under certain conditions. Although neither the Code nor the Regulations offer a precise definition of property that will qualify for a section 1031 exchange, they do offer a broad description of the classes of property that will and will not qualify.

The property must be property held by the taxpayer for productive use in a trade or business or for investment. Non-business property such as a personal residence, or an automobile used solely for personal purposes will not qualify. Whether property is being held for productive use in a trade or business or for investment is a question of fact, to be determined by the actual use of the property *at the time of the exchange.*[21] The test is applied to each party to the exchange separately. It is possible for any particular transaction to be a qualified exchange for one of the parties and at the same time a wholly taxable event for the other.[22] In addition, the section specifically excludes from coverage stock in trade, property held primarily for sale, stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.

2. *Productive Use in a Trade or Business*

The phrase "held for productive use in a trade or business" is not defined by either the Code or the Regulations, nor has there been any significant guidance from the courts concerning this specific language. However, similar but not identical language is contained in Code section 1231 relating to the recognition of gain or loss on the disposition of certain property "used in a trade or business,"[23] and section 167 relating to certain depreciation deductions for "property used in a trade or business."[24]

In *Independent Brick Co.*,[25] the court, in discussing predecessor provisions of both of the above code sections, reasoned with the taxpayer in agreeing that, because the loss on the disposition of

21. Heiner v. Tindle, 276 U.S. 582 (1928); Rev. Rul. 57-244, 1957-1 C.B. 247.
22. Rev. Rul. 66-209, 1966-1 C.B. 299.
23. INT. REV. CODE of 1954, § 1231(a).
24. *Id.* § 167(a)(1).
25. 11 B.T.A. 860 (1928).

a sand processing machine resulted from a transaction entered into in furtherance of its business, the loss was in connection with the operations of the business. It could therefore be included as a loss on the disposition of "property used in a trade or business." However, the court went on to hold that the property's classification as "property used in a trade or business" did not cease for the years 1913 and 1914 simply because the machine was not used by the taxpayer in those years.[26] This interpretation of the language has been developed and refined through the years to the extent that the court in *Alamo Broadcasting Co., Inc.*[27] stated the rule to be that "used in a trade or business means devoted to the trade or business and includes property purchased with a view to its future use in the business even though this purpose is later thwarted by circumstances beyond the taxpayer's control."[28]

The cases under section 167 have followed a parallel line of reasoning. In *Kittredge v. Commissioner*,[29] the court specifically rejected the idea that property was not used in a trade or business unless it was actively employed in that business. In *Carter-Colton Cigar Co.*,[30] the court, citing an earlier case, stated:

> The acquisition of real estate for use at its principal place of business by a corporation is a proper business purpose and function, and the real estate so purchased, in our opinion, is devoted to and 'used in' the business of the corporation during the planning and building stages preparatory to actual occupancy. Its character as 'real property used in . . . trade or business' continues even after the planned use becomes impossible.[31]

In *Sears Oil Co., Inc. v. Commissioner*,[32] the court held that property would qualify if it was available for use should the occasion arise even if in fact it was not so used. In *Yellow Cab Co. of Pittsurgh v. Driscoll*,[33] the property was held to have been held for use in the taxpayer's trade or business, even though it was bought, held for several years, and sold without ever having been actually utilized by the taxpayer.

While a review of the above case law is important to an understanding of section 1031(a), the law there proclaimed cannot be considered definitive. Those cases were not considering the language of section 1031(a). Section 1031(a) has added the word "productive" to the description of qualifying property, requiring that property be held for *productive* use in a trade or business rather than simply "for use in a trade or business" as required in Code section 1231 and 167.

26. *Id.* at 869.
27. 15 T.C. 529 (1950), *acquiesced in*, 1951-1 C.B. 1.
28. *Id.* at 541.
29. 88 F.2d 632 (2d Cir. 1937).
30. 9 T.C. 219 (1947), *acquiesced in*, 1947-2 C.B. 1.
31. *Id.* at 221.
32. 359 F.2d 191 (2d Cir. 1966).
33. 24 F. Supp. 993 (W.D. Pa. 1938).

The intended distinction between the provisions is not clear. However, it is apparent that 1031 establishes a more restrictive requirement. In this context it should be remembered that Congress was making a fundamental change in the 1918 Act by enacting the predecessor to section 1031—rather than taxing all exchanges, some were to be exempt. Such exemptions have always been limited in scope. In addition it might be assumed that Congress, at the time, was aware of the judiciary's propensity to interpret the "for use in a trade or business" phraseology to permit inclusion of property not actually utilized in a taxpayer's business. The addition of the word "productive" may have been directed to circumscribing this approach to section 1031(a).

On its face the section would seem to require that the property be *actively* utilized in or contribute to a taxpayer's business activity. Some small support for this proposition can be found in the case of *William J. Wineberg*,[34] in which the Tax Court stated that, although timberlands under a reforestation program might be considered as held for productive use in a trade or business, standing timber could not. Although the decision was not made on this ground, it seems clear that in this statement the court is implying, at least, some requirement of a producing activity in the business.

If the requirement is that there be some active utilization of the property in the taxpayer's business, there remains unanswered the question of the status of property being prepared or constructed for use in the trade or business and of property retired from use. Would qualification of the property date from its utilization in the business? Would the exchange have to take place while property is still actively employed by the taxpayer?

3. *Investment Property*

Neither the Code nor the Regulations define the term "investment" for purposes of section 1031(a). The Regulations, however, offer one description of investment property: "unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale."[35]

As indicated by the Regulations, the commonly accepted concept of an investment is the passive holding of property, usually for some time more than a temporary period, with the expectation that market considerations will cause it to appreciate in value. For the

34. 20 T.C.M. 1715 (1961), *aff'd*, 326 F.2d 159 (9th Cir. 1963).
35. Treas. Regs. § 1.031(b).

most part the judicial and administrative commentary concerning the term "investment" for purposes of section 1031(a) has been confined to what it is not rather than what it is. Property held for sale in the immediate future is not held for investment.[36] However, property is not disqualified if it is held for ultimate sale but not in the immediate future.[37] Real estate acquired by a bank in a mortgage foreclosure was not held for investment since it was continually offered for sale by the usual real estate methods.[38] Nor is property held for investment where it is acquired subject to a binding sales contract.[39]

4. *Time When Holding for a Qualifying Purpose Begins or Ends*

Under normal circumstances the purpose for which property is held will be determined when the property is acquired. As noted above relative to the discussion of the business use phraseology under section 1031(a), if the property was acquired for a qualifying purpose, it may continue to be qualifying property in the hands of a taxpayer even though it is never put to a qualified use in the taxpayer's business. However, under certain circumstances, the classification of the property in the hands of the taxpayer may change in the course of his ownership. In *Klarkowski v. Commissioner*,[40] the Seventh Circuit Court of Appeals stated: "The principle purpose at the time of acquisition is not necessarily a controlling factor in determining the principal purpose or purpose of first importance of the holding at the time of sale."[41]

As stated previously, although factors before and after an exchange may be considered in determining the classification of property, the critical point in time for determining whether property is held for a qualifying use is at the time of the exchange. In Revenue Ruling 57-244,[42] the Service considered the circumstances of three taxpayers who purchased property for the construction of homes and later abandoned that purpose for clearly established personal reasons but continued to hold the property for investment purposes. A subsequent exchange was held to qualify as a section 1031 exchange. Presumably, this rationale would also apply to a situation in which a taxpayer put his personal residence up for rent. At that point the character of the property in his hands has changed and the property would thereafter be qualified for a section 1031 exchange.

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36. Regals Realty Co. v. Commissioner, 127 F.2d 931 (2d Cir. 1942).
37. Loughborough Development Corp., 29 B.T.A. 95 (1933), *acquiesced in*, XII-2 C.B. 9.
38. Harr v. MacLaughlin, 15 F. Supp. 1004 (E.D. Pa. 1936).
39. Brooks Griffin, 49 T.C. 253 (1967).
40. 385 F.2d 398 (7th Cir. 1967).
41. *Id.* at 400.
42. Rev. Rul. 57-244.

How far a taxpayer can go in arranging his transaction to qualify as a nonrecognition exchange under section 1031 is not clear. However, the courts have held that the mere fact a taxpayer did make such arrangements for tax avoidance purposes was not sufficient to disqualify the exchange.[43] Such arrangements are the core of the currently popular three-party transactions discussed later in this Article.[44] The real problem in these situations is proving the change in character of the property. This, of course, will involve the classic exercise of considering all the facts and circumstances in each case.

5. *Property Specifically Excluded from Section 1031 Treatment*

Section 1031(a) specifically excludes from coverage exchanges of stock in trade or other property held primarily for sale, stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, and other securities or evidences of indebtedness or interest. While certainly each of these may relate in some manner to real estate exchanges, only property held as stock in trade and primarily for sale will be considered in this Article as having particular significance in real estate transactions.

The key to understanding the exceptions from section 1031 application for stock in trade and property held primarily for sale relates to the discussion above restricting nonrecognition treatment to investment or business property. The original objective of the statute was to alleviate the difficulty of valuing such property. However, it is logical to assume that a taxpayer holding property primarily for sale or as stock in trade has resolved the problem of valuation. Property held primarily for sale or as stock in trade or property which is in fact sold immediately after an otherwise nonrecognition exchange cannot logically be said to be without a readily realizable market value.[45]

a. *Held Primarily For Sale*

The phrase "held primarily for sale" is, in essence, descriptive of a state of mind. As used in section 1031(a), it refers to the taxpayer's intention with regard to his holding or disposition of prop-

43. Mercantile Trust Co. of Baltimore, 32 B.T.A. 82 (1943), *acquiesced in*, XIV-1 C.B. 13; Carlton v. United States, 255 F. Supp. 812 (S.D. Fla. 1966), *aff'd*, 385 F.2d 238 (5th Cir. 1967); Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968).
44. *See* notes 159-67 and accompanying text *infra*.
45. *See* notes 46-55 and accompanying text *infra*.

erty. This state of mind is determined at the time of the exchange.[46] However, events preceding and following the subject exchange will be considered as indicative of his state of mind at that time.

The language of section 1031, while comparable to, must be distinguished from the provisions of section 1221 and 1231 of the Code. Section 1221(1) of the Code, relating to the definition of capital assets, refers to:

> [s]tock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.[46a]

Section 1231 uses practically identical language and again refers to property that would be includable in a taxpayer's inventory or which is held "for sale to customers in the ordinary course of a trade or business." In each instance, the reference is to property held for *sale in the course of some business activity.*[47] This is not a requirement under the language of section 1031(a) which refers only to property held for *sale.* Whether or not such holding is in the course of some business activity of the taxpayer is irrelevant, except, of course, that property so held would certainly be excluded by the language of 1031(a).

Nevertheless, reference may be made to the cases under sections 1221 and 1231 for a useful definition of the word "primarily" as used in the context of section 1031(a). The courts have held on numerous occasions that the word "primarily" does not mean chiefly or predominantly but rather merely substantially or essentially.[48]

In the context of the section 1031(a) exclusion of property held primarily for sale, it is important to make a distinction between this exclusion and the requirement that after a qualified exchange the taxpayer intends to hold the property for productive use in a trade or business or for investment.[49] In seeking satisfaction of the latter requirement, the inquiry shifts from whether the property is held primarily for sale or whether it is held for the requisite business or investment purpose.

b. *Stock in Trade*

Stock in trade is a particular type of property held primarily for sale. Stock in trade is business property and usually refers to property held as inventory for sale to customers. In terms of real

46. Klarkowski v. Commissioner, 385 F.2d 398 (7th Cir. 1967).
46a. INT. REV. CODE of 1954, § 1221(1).
47. Recordak Corp. v. United States, 325 F.2d 460 (Ct. Cl. 1963).
48. American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963), *cert. denied,* 375 U.S. 993 (1964); Goodman v. United States, 390 F.2d 915 (Ct. Cl. 1968); Recordak Corp. v. United States, 325 F.2d 460 (Ct. Cl. 1963).
49. *See* notes 89-92 and accompanying text *infra.*

estate transactions, inventory is normally a concept confined to real estate dealers. However, it is not always a simple matter to distinguish between a dealer and an investor. In *Winter Holding Corporation*,[50] the court held that in determining whether a corporation is engaged in a particular business, inquiry must be made into the regularity or persistence with which that particular business is pursued. If the transactions are found to be infrequent, casual or isolated, "the consequence of occasional convenience rather than endeavor,"[51] the corporation is not engaged in the business in question. The test is pragmatic rather than theoretical. In this case a parcel of real estate was held for nine years during which time it was profitable. In the tenth year it became unprofitable and was sold. This sale did not make the corporation a dealer.

Another factor considered by the courts is the nature of the property purchased by the taxpayer. In *Biscayne Trust Co.*,[52] the court considered the condition of the real estate and whether it had any market value at the time of taxpayer's acquisition. The court noted the desolate condition of the property in some detail and the fact that the land boom in the area did not start until sometime after the taxpayer's acquisition of the property. Based on these facts and other considerations similar to those mentioned above, the court held that the taxpayer was an investor and not a dealer. In holding that a bank which had acquired properties by mortgage foreclosures was a dealer, the court in *Harr v. MacLaughlin*[53] found controlling the fact that in three years the taxpayer sold seventeen out of twenty-nine properties, by bank policy held such real estate for resale and in fact, continually offered the property for sale by the usual real estate methods. However, it has been held that the failure to advertise property is not a controlling factor if the taxpayer had an alternative means of disposal available. In the *Wineberg*[54] case the Tax Court made an excellent summarization of the criteria for consideration in determining whether a taxpayer is engaged in a business and therefore a dealer:

> What constitutes a trade or business is a question of fact. Many factors have been considered by the courts in the determination of this question, among them, the nature of the acquisition of the property, the frequency and continuity of transactions over a period of time as distinguished

50. 31 B.T.A. 1185 (1935).
51. *Id.*
52. 18 B.T.A. 1015 (1930), *acquiesced in*, IX-2 C.B. 6.
53. 15 F. Supp. 1004 (E.D. Pa. 1936).
54. William J. Wineberg, 20 T.C.M. 1715 (1963), *aff'd*, 326 F.2d 159 (9th Cir. 1963).

from isolated transactions, substantiality of transactions, and the activity of the seller with respect to the property.[55]

Having qualified the property with which the taxpayer proposes to deal, it is next necessary to qualify the transaction in which he proposes to take part. The only transaction that will qualify for nonrecognition under section 1031(a) is an exchange. No other financial arrangement will suffice.

6. *Exchange Versus Sale or Other Transaction*

a. *Definition of Exchange*

An exchange contemplates a "mutual grant of equal interests, the one in consideration of the other."[56] Generally, an exchange of property accompanied by an immediate repurchase of property is not a sale "because the basis of the transaction is measured in money."[57] However, section 1031 does not require a pure exchange. Subsection 1031(b) permits nonexchange benefits, *i.e.*, cash, assumption of liabilities, etc., to accompany an otherwise pure exchange of property. As is the case with so many tax considerations, to determine whether there is truly an exchange, the courts will look at the transaction in its entirety to determine the substance of a transaction. In this regard, if the transaction otherwise qualifies as a nonrecognition exchange, it is not material that the taxpayer designed the transaction to effect an exchange as a means of avoiding taxes.[58]

Following these guidelines, the Third Circuit Court of Appeals, in *Allegheny County Auto Mart, Inc. v. Commissioners*,[59] found that two separate sales were really separate parts of a single transaction which taken together constituted an exchange. In that case, a taxpayer purchased a piece of property and contemporaneously sold a similar piece of property to the seller of the first property. In a somewhat related circumstance, the Service, in Revenue Ruling 57-469,[60] held that a qualified exchange occurred when land belonging to an incompetent was sold and other property purchased by means of a sale and purchase agreement. The key to the result was the fact that the parties wanted to effect a taxfree exchange but were prevented from exchanging the property by state law. Of course, all other factors necessary to qualify the exchange were present.

This rationale was extended in *J.H. Baird Publishing Com-*

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55. *Id.* at 1746.
56. Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1945).
57. *Id.* at 36.
58. Mercantile Trust Co. of Baltimore, 32 B.T.A. 82 (1935), *acquiesced in*, XIV-1 C.B. 13; Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963).
59. 208 F.2d 693 (3d Cir. 1953).
60. Rev. Rul. 57-469, 1957-2 C.B. 521.

pany.[61] In *Baird* the taxpayer deeded qualifying property to a real estate agent but retained the use of the property until the agent could acquire a lot, construct a building on it and transfer it to the taxpayer. The real estate agent sold taxpayer's property subject to the use and with the proceeds, acquired the desired property, built the building and transferred it, along with cash, to the taxpayer. Several months elapsed between the first part of the exchange and the last. The court held that each of these steps were integral parts of a single transaction which, when taken together, constituted an exchange. The key factor noted by the court was the fact that the taxpayer had refused to sell the property and would only go into the transaction if it were a qualified exchange.

The three-party transaction as utilized in *Baird,* however, can be a trap for the careless. The courts have held that an exchange cannot be effected by one who does not have title to the property he purports to transfer. When an exchange is contemplated, title to the property involved must be vested in the party making the transfer *at the time he makes the transfer.* In several cases, the multi-party transactions have been so constructed that one of the parties never actually acquired fee title to property but rather was possessed of some lesser interest such as an option to buy.[62] Such an oversight is fatal to an attempted nonrecognition transaction. Nor is this particular problem confined to multi-party exchanges. In one instance, a taxpayer contracted for the construction of a new plant on its property. As part of the arrangement, the taxpayer transferrred the old plant to the contractor to apply to the construction costs. At no time did the contractor own either the new building or the land on which it was built. The court held that there was no exchange but rather a sale and purchase transaction.[63] In another instance, a taxpayer offered certain mining leases to a mining corporation in exchange for overriding royalties on the subject properties. The mining corporation wanted the property but objected to the terms of the leases. To eliminate these objections, the taxpayer had his leases cancelled and the property included in leases already in existence between the corporation and the landowner. The court held that there was no exchange because, at the time of the transaction, the taxpayer had no property to exchange.[64] He had cancelled his leases and had no further rights in the prop-

61. 39 T.C. 608 (1962), *acquiesced in,* 1963-2 C.B. 4.
62. Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968).
63. Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1950).
64. Badgett v. United States, 175 F. Supp. 120 (W.D. Ky. 1959).

erty. Why the court did not apply the step transaction doctrine is not clear. Certainly the doctrine would have seemed appropriate in this instance.

b. *Sale and Lease-Back*

A procedure frequently utilized in recent years which has resulted in much litigation to determine whether there has been a sale or an exchange is the sale and lease-back transaction. In most intances the transaction involves a taxpayer who wants to sell property in order to realize a loss or to substitute rental payments for diminished depreciation deductions, but does not want to be deprived of the use of the property. This goal is usually achieved by selling the property in question and taking back an extended term lease on the same property.

The difficult question for the taxpayer in these circumstances is whether, in reality, he has changed his economic position. A key consideration in this regard is the term of the lease taken back. If the lease is of long duration, it may be considered sufficiently similar to a fee interest in the real estate to cause the transaction to be classified as a nonrecognition exchange. The regulations provide that if the lease is for thirty years or more, the transaction will be so classified.[65] While no court has been called upon to decide the validity of the regulation, they have considered the basic transaction on several occasions.

In *Standard Envelope Manufacturing Co.*,[66] the taxpayer sold property and took back a one year lease with an option to renew for twenty-four years. It exercised the option and the Service sought to disallow a substantial loss claimed by the taxpayer. The Service contended that the transaction was a sham and that the taxpayer had not changed his economic position. The Tax Court held that the transaction was a sale. Its decision was based on several considerations among which were: (1) the rental agreed to be paid was reasonable; (2) there was an arms-length transaction; (3) the taxpayer had other nontax reasons for making the sale; and (4) the lease was for less than thirty years and was therefore not the equivalent of a fee simple estate under the Regulations.

It is not clear from the court's decision which, if any, of the several factors considered was given more weight than the others. The court did not rule on the validity of the Regulation but merely cited it. However, it is doubtful that the court would have spent so much time discussing the several other factors if it had felt totally comfortable with the thirty-year language of the Regulation.

In *Century Electric Co. v. Commissioner*,[67] the Eighth Circuit Court of Appeals reached a different conclusion. In that case, the

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65. Treas. Reg. § 1.1031(a)-1(c), T.D. 6935, 1967-2 C.B. 272.
66. 15 T.C. 41 (1950), *acquiesced in*, 1950-2 C.B. 4.
67. 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952).

taxpayer transferred property for cash and a ninety-five year lease. The court held that the taxpayer had not changed his economic position and had in reality effected an exchange rather than a sale. Facts cited as significant by the court included: (1) the taxpayer had transferred his whole business; (2) the taxpayer thus could not continue in business unless he could lease back the property; and (3) the lease was for ninety-five years.

However, this case should not be considered as directly contrary to *Standard Envelope Manufacturing Company.* This court, as did the Tax Court, mentioned the thirty-year provision in the Regulations but did not rule on its validity. The most significant distinction between the two cases was the almost total absence in *Century Electric Co.* of substantial evidence of the reasonableness of the business deal and of nontax motives for the transaction. A great deal of evidence on these factors was offered in *Standard Envelope Manufacturing Company.*

The importance of the distinction is illustrated by the Second Circuit Court of Appeals' decision in *Jordan Marsh v. Commissioner.*[68] In that case, the taxpayer transferred property in exchange for a lease of thirty years and three days. The court held that there was a sale. It distinguished *Century Electric Co.* for the specific reasons suggested above for distinguishing it from *Standard Envelope Manufacturing Co.* The court's ruling was based squarely on the fact that the business arrangements were reasonable and there existed substantial nontax motives for the transaction. Again, the court did not rule on the validity of the Regulation. The Service does not acquiesce in this decision.

In *City Investing Company and Subsidiaries,*[69] the Tax Court, although stating that it was distinguishing the *Jordan Marsh* decision, proceeded to find that the transaction was a sale on substantially the same type of considerations. In each of the above cases, it was the substance of the transaction as proved to the court which controlled the result. In all probability, if a taxpayer can demonstrate valid nontax motives for his transfer, can prove that there was an arms-length transaction and that the values of the property transferred and received are reasonable, the length of his lease term will not control the tax results of his transaction.

7. *Like-Kind Property*

In addition to the requirement that qualified property be trans-

68. 269 F.2d 453 (2d Cir. 1959).
69. 38 T.C. 1 (1962), *non-acquiesced in,* 1963-2 C.B. 6.

ferred in a qualified exchange, section 1031(a) will apply only if the properties exchanged are of like-kind. The Regulations provide:

> [T]he words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. . . .[70]
>
> No gain or loss is recognized if . . . (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate . . . .[71]

The application of the "like kind" requirement to real estate exchanges is extremely broad. It refers to the broad classes of property such as real or personal but not to distinctions between tracts of real property even where there are substantial dissimilarities in location, physical attributes or possibilities for productive utilization.[72] The exchange of real estate held for investment with real estate held for productive use in a trade or business may be a "like kind" exchange if the transaction is otherwise qualified.[73] To determine whether real estate exchanges qualify as "like kind" exchanges, reference must be made to the nature of the rights or interests in the real estate which are exchanged. The rights in the respective grantees to the property exchanged must be of the same general character or substantial equality.[74]

a. *Importance of State Law*

State law may be a significant factor in determining the nature of the various rights and interests in real estate. The United States Supreme Court has held that state law controls in determining the nature of the legal interest of a taxpayer in property.[75] This principle has been applied to section 1031 exchanges. The Fifth Circuit Court of Appeals has held that, because under Louisiana law mineral rights are interests in real property, an exchange of mineral rights for a city lot was a "like kind" exchange under section 1031(a).[76] Where, under applicable state law, water rights are considered interests in real property, an exchange of perpetual water

70. Treas. Reg. § 1.1031(a)-1(b), T.D. 6935, 1967-2 C.B. 272.
71. Treas. Reg. § 1.1031(a)-1(c)(2), T.D. 6935, 1967-2 C.B. 272.
72. Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).
73. Treas. Reg. § 1.1031(a)-1, T.D. 6935, 1967-2 C.B. 272.
74. W. Fleming, 24 T.C. 818 (1955), *non-acquiesced in*, 1965-1 C.B. 6, *rev'd on other grounds*, 241 F.2d 78 (5th Cir. 1957).
75. Morgan v. Commissioner, 309 U.S. 78 (1940).
76. Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941); Rev. Rul. 68-331, 1968-1 C.B. 352.

rights for a fee interest in real estate was held to be a "like kind" exchange.[77] In *Oregon Lumber Co.*,[78] the Tax Court referred to decisions of the Oregon Supreme Court to determine if the right to cut and remove standing timber was personalty or an interest in real estate. Because Oregon had held such a right to be personal property, it was so held for the purposes of applying section 1031.

b. *Real Property Distinguished from Personal Property*

Because real property and personal property are different classes of property, exchanges of the two are not "like kind" exchanges. In *Oregon Lumber Co.*, the taxpayer conveyed a fee interest in timberland to the United States in exchange for the right to cut and remove timber of equal value from certain national forests. The court held that the exchange was of real property for a license to remove the timber and therefore was not an exchange of "like kind" property.

In Revenue Ruling 72-151,[79] the Service held that an exchange of rental real property consisting of land and a house for farm real estate was a "like kind" exchange. However, to the extent farm machinery was included in the exchange, there was a transfer of other property not of "like kind" and gain was recognizable to the extent of the value of the farm machinery.

In *Red River Lumber Company v. United States*,[80] the taxpayer exchanged certain unimproved real property for improved realty but leased the improved realty back to the other party for a rental consisting of a right to use certain electrical energy. The court held that the exchange of an interest in real estate for a right to use electricity was not a "like kind" exchange.

c. *Property Distinguished from Income from the Use of Property*

The exchange of property for the right to receive income from the use of property is not a "like kind" exchange for purposes of section 1031. In *Commissioner v. P.G. Lake, Inc.*,[81] the United States Supreme Court held that oil and sulphur payment rights were in reality the right to receive income from the use of land and not interests in the land itself. Consequently, an exchange of these

77. Rev. Rul. 55-749, 1955-2 C.B. 295.
78. 20 T.C. 192 (1953), *acquiesced in*, 1953-2 C.B. 5.
79. Rev. Rul. 72-151, 1972-1 C.B. 225.
80. 139 F. Supp. 148 (Ct. Cl. 1956).
81. 356 U.S. 260 (1958).

rights for a ranch and other realty did not constitute a "like kind" exchange of property.

Revenue Ruling 66-209,[82] citing a long list of authorities, held that realty exchange for advanced rental income was not a "like kind" exchange. In that ruling, the Service was considering the tax consequences of a transaction in which a taxpayer who owned two parcels of real estate received a fee interest in a third parcel in exchange for the execution of a lease on all three properties. The Service held that while the transferor-lessee had made a qualified section 1031 exchange, the transferee-lessor had realized advance rental income to the extent of the value of the fee interest received. The key to the result reached in this ruling is the rental income fixed for the properties. The rental for the first year was only $25,000. For each year thereafter, it was $80,000 or more. Obviously, the agreement between the parties contemplated an allocation of some portion of the first year's rental income to the value of the fee interest received. Similarly, anytime the performance of services constitutes a part of an exchange, the transaction should be reviewed carefully to be certain the desired section 1031 exchange will result.

d. *Multiple Asset Exchanges*

Under certain circumstances, it may be possible to exchange one business for another, each consisting of a variety of assets. However, each asset must be qualified property and must be exchanged for like-kind property. The fundamental principles governing such a transaction are concisely stated in Revenue Ruling 55-79:

> For Federal income tax purposes, the sale of a going business . . . does not constitute the sale of a single asset. Such a sale constitutes a sale of the individual assets comprising the business.[83]

The ruling is concerned with the computation of capital gains and losses and goes on to say that each asset must be separately classified and separately valued as a portion of the whole. The ruling is based on the earlier case of *Williams v. McGowan*,[84] which dealt with the sale of a hardware business as a going concern. The court held that the business was not to be treated as a single asset but was to be converted into its fragments and these would be separately matched against the Code definition of a capital asset.

Citing *Williams v. McGowan* and Revenue Ruling 55-79, Revenue Ruling 57-365, provides that when one company exchanges

> all of its assets, including both real estate and personal property (but not including items of inventory and securi-

82. Rev. Rul. 66-209, 1966-2 C.B. 299.
83. Rev. Rul. 55-79, 1955-1 C.B. 370.
84. 154 F.2d 570 (2d Cir. 1945).

> ties), for all of the similar assets of another operating telephone company and cash to equalize the value of the assets exchanged, an exchange of the assets of one such business for identical assets of another such business will be considered an exchange of "property of like kind" within the meaning of section 1031 of the Code, on which, pursuant to the provisions of section 1031(b), gain, if any, will be recognized only to the extent of the cash received.[85]

The key to the ruling would appear to be its requirement that the exchange be for "identical assets." Apparently, the requirement is that there be an asset for asset comparison. It is not clear whether quantity and value comparison is also anticipated. However, such a comparison would seem inappropriate as being in the nature of a grade or quality comparison and contrary to the Regulations and several cases previously discussed. Nevertheless, some concern would be in order if the relative values of the classes exchanged were flagrantly distorted. The courts will still look to the substance of the transaction to determine if in fact there was a "like kind" exchange.

In Revenue Ruling 59-229,[86] the Service held that an exchange of unencumbered farm lands, farm buildings, and unharvested crops for like property was a qualified exchange. However, any gain resulting from the reciprocal assumption of mortgages was to be recognized and the exchange of personal residences was to be considered a separate exchange governed by the appropriate provisions of Code section 1034. A similar result was reached in Revenue Ruling 72-151,[87] concerning an exchange of farm property for rental property.

e. *Leasehold Exchange for Fee Interest*

Regulations section 1.1031(a)-1(c)(2) provides that an exchange of a leasehold of thirty years or more for a fee interest will be an exchange to which section 1031(a) will be applicable. While the Service has followed this rule, no court has yet been required to rule directly on the validity of the Regulation. In practically every case coming before the courts, the transfer of the leasehold interest has been contemporaneous with a sale of the same property. In those instances, the courts have concerned themselves with the validity of the sale.[88] Accordingly, the current status of the regulation as applied to leases greater than thirty years is unclear.

85. Rev. Rul. 57-365, 1957-2 C.B. 521.
86. Rev. Rul. 59-229, 1959-2 C.B. 180.
87. Rev. Rul. 72-151 *supra* note 79.
88. *See* notes 56-64 and accompanying text *supra*.

8. *Property Received to be Held for Productive Use in a Trade or Business or Investment*

The final requirement for a qualified exchange is that the property received must be held either for investment or for productive use in a trade or business. Consequently, section 1031 will not be applicable to an exchange if the property exchanged is acquired for resale.[89] Property acquired in an otherwise qualified exchange was held not qualified where it was previously committed to resale.[90] In *Ethel Black,*[91] the taxpayer exchanged desert land for a house which she repaired and sold. The court held that the transaction was not entitled to nonrecognition treatment because the property was held primarily for sale.

The requirement here is essentially the same as discussed above with reference to qualifying property for exchange.[92] The significant point is that the requirement is a condition subsequent that may cause an otherwise qualified exchange to be disqualified some point in time after the exchange has been effected. How long property must be held is not clear. It would seem sufficient if the original intent of the taxpayer was to hold it for a qualifying purpose. However, intent is difficult to prove and a sale too soon after the exchange may be considered indicative of the taxpayer's intent at the time of the exchange. Such a presumption may be overcome if the taxpayer is able to show a significant change in circumstances which make a sale appropriate.

B. *Gain from Exchanges Not Solely in Kind*

1. *Transfer of Unqualified Property*

The nonrecognition provisions of section 1031 are applicable only to exchanges of the certain qualified property described in section 1031(a) of the Code. The Regulations provide:

> A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).[93]

Consequently, if a taxpayer transfers qualified plus unqualified property in exchange for qualified property, he must recognize any gain or loss realized on the transfer of the unqualified property.

89. Regals Realty Co. v. Commissioner, 127 F.2d 931 (2d Cir. 1942).
90. 49 T.C. 253 (1967).
91. 35 T.C. 90 (1960).
92. *See* notes 134-38 and accompanying text *infra.*
93. Treas. Reg. § 1.1031(a)-1(a), T.D. 6935, 1967-2 C.B. 272. *See also* R. & M. Property Co., 27 B.T.A. 436 (1932) and Allegheny County Auto Mart, Inc., 12 T.C.M. 427, *aff'd,* 208 F.2d 693 (3d Cir. 1953).

Recognition will be pursuant to the general provisions of sections 1001 and 1002 of the Code. For this purpose, the taxpayer is deemed to have received in exchange for the unqualified property an amount equal to its fair market value on the date of the exchange.[94] However, no gain or loss is recognized if a taxpayer transfers qualified property together with cash in exchange for qualified property.[95] Nor will the transfer of qualified property together with unqualified property disqualify the exchange with respect to the qualified property.[96]

The application of these principles as they relate to recognition of a loss is well illustrated by an example contained in the Regulations:

> A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $10,000 and a fair market value of $11,000. The stock transferred has an adjusted basis of $4,000 and a fair market value of $2,000. The real estate acquired has a fair market value of $13,000. A is deemed to have received a $2,000 portion of the acquired real estate in exchange for the stock, since $2,000 is the fair market value of the stock at the time of the exchange. A $2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. . . .[97]

These principles are equally applicable to recognition of gain. It should also be noted that whether a particular property is qualified or not depends on the nature of each exchange. Otherwise qualified real estate will not be qualified property if it is part of an exchange of personal property. There must be an exchange of like-kind property or an exchange, or part of it, will not be qualified regardless of the type of property involved.

2. *Receipt of Unqualified Property*

Contrary to the transfer of unqualified property, the Code and Regulations under section 1031(b) make very specific provisions for the receipt of unqualified property in an otherwise qualified exchange. If a taxpayer receives, in a section 1031 exchange, other property or money in addition to property permitted to be received

94. Treas. Reg. § 1.1031(d)-1(e), T.D. 6935, 1967-2 C.B. 272.
95. Treas. Reg. § 1.1031(a)-1(c), T.D. 6935, 1967-2 C.B. 272; W. H. Hartman Co., 20 B.T.A. 302 (1930).
96. Treas. Reg. § 1.1031(a)-1(a), T.D. 6935, 1967-2 C.B. 272.
97. Treas. Reg. § 1.1031(d)-1(e), T.D. 6935, 1967-2 C.B. 272.

without recognition of gain or loss, any gain realized must be recognized but only in an amount not in excess of the fair market value of the other property and/or the sum of money received.[98] For purposes of section 1031(b), "other property or money" includes liabilities transferred, property not eligible for nonrecognition treatment under section 1031(a), and property, which though eligible by definition, is not of like-kind to the other property involved in the exchange.

a. *Receipt of Money*

The receipt of cash in partial consideration for the exchange of property is tantamount to a partial sale of the property and will cause the recognition of any gain accordingly. If the taxpayer *realizes* gain on a section 1031 exchange, he will *recognize* his gain to the extent of the cash received. It has been held that where cash is advanced by the transferor to enable the transferee to pay off a mortgage on the property he is exchanging, the transferee has not realized a gain but rather merely changed creditors.[99] However, if there is no requirement that the money be used to pay off the mortgage, the receipt of the cash will be treated as taxable gain.[100]

It is important to note the two limitations on recognition, *i.e.*, the lesser of the gain realized or the cash received. An example from section 1.1031(b)-1 of the Regulations illustrates the principle well:

> A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in a trade or business) which has a fair market value of $6,000, and $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.[101]

Recognition of the remaining gain is deferred under the general provisions of section 1031(a).

The cash giving rise to the recognition of gain is the net cash received. Thus, in Revenue Ruling 72-456,[102] a taxpayer was allowed to deduct brokerage commissions from the cash he received and recognized gain only on the net. In *Gabe P. Allen*,[103] the "expenses incurred in connection with the sale" were permitted to reduce the cash realized from $62,500 to $24,358.26.

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98. INT. REV. CODE of 1954, § 1031(b); Treas. Reg. § 1.1031(b)-1(a), T.D. 6935, 1967-2 C.B. 272.

99. Commissioner v. North Shore Bus Co., Inc., 143 F.2d 114 (2d Cir. 1944).

100. Coleman v. Commissioner, 18 F.2d 758 (8th Cir. 1950).

101. Treas. Reg. § 1.1031(b)-1(b)(1), T.D. 6935, 1967-2 C.B. 272. *See also* Leach v. Commissioner, 91 F.2d 551 (6th Cir. 1937).

102. Rev. Rul. 72-456, 1972-1 C.B. 468.

103. 10 T.C. 413 (1948).

b. *Liabilities*

Regulations section 1.1031(b)-1(c) provides that:

> Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of section 1031(b) . . . .[103a]

The Code contains no such specific reference and the language first appeared in the Regulations in 1956.[104] However, the proposition found support in the courts[105] and administrative rulings[106] for many years prior to the 1954 Revenue Act.

Under this provision, when the taxpayer transfers mortgaged property in an exchange and receives unencumbered property, the amount of the mortgage is treated as money received by the taxpayer.[107] This result is the same whether or not the mortgage is assumed by the transferee. In *Allen*,[108] the taxpayer transferred mortgaged real estate for unencumbered properties plus cash. The transferee took the property subject to the mortgage but did not assume it. The Tax Court held that it was a well established proposition of law that the mortgage indebtedness constituted "other property or money" whether or not the transferee assumed it.

3. *Netting Unqualified Property*

a. *Netting Liabilities*

Under limited circumstances, parties to an otherwise qualified exchange who each give and receive unqualified property may offset the unqualified property given against the unqualified property received. The Regulations specifically provide for offsetting liabilities:

> Where on an exchange . . . each party . . . either assumes a liability of the other party or acquires property subject to a liability, then in determining the amount of "other property or money" . . . consideration given in the form of an assumption of liabilities (or receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability).[109]

103a. TREAS. REG. §§ 1.1031(b)-1(c).
104. Treas. Dec. 6210, 1956-2 C.B. 508.
105. Brons Hotels, Inc., 34 B.T.A. 376 (1936).
106. G.C.M. 4935, VII-2 C.B. 112 (obsolete).
107. Brons Hotels, Inc., 34 B.T.A. 376 (1936); G.C.M. 4935, VII-2 C.B. 112 (obsolete); Gabe P. Allen, 10 T.C. 413 (1948); Robert W. Aagaard, 56 T.C. 191 (1971).
108. Gabe P. Allen, 10 T.C. 413 (1948).
109. Treas. Reg. § 1.1031(b)-1(c), T.D. 6935, 1967-2 C.B. 272.

In Revenue Ruling 59-229,[110] citing G.C.M. 2641,[111] the Service stated that it was a long established rule that a balancing of liabilities will be permitted when mortgaged property is exchanged for mortgaged property and each party assumes the mortgage of the other property. Thus, the measure of gain to be recognized in such a reciprocal assumption of liabilities is the extent to which the taxpayer realizes a net reduction in indebtedness. Moreover, the examples under Regulations section 1.1031(d)-2 illustrate that other forms of unqualified property may also be used to offset the amount of "other property or money" received.

b. *Netting Property Other Than Liabilities*

Example (2)(c) under Regulations section 1.1031(d)-2 provides that consideration received by a taxpayer in transferring property subject to a liability of $150,000 may be offset by consideration given in the form of the receipt of property subject to an $80,000 mortgage and $40,000 cash paid by the taxpayer. The rule is stated in the example as follows:

> Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability. . . .[111a]

In other words, cash and other unqualified property given may offset consideration received in the form of an indebtedness of which the taxpayer is relieved.

4. *Apportionment of Unqualified Property*

One of the most difficult problems with the application of section 1031 to a transfer of property is the apportionment of the gain realized from the receipt of unqualified property among the properties transferred. The difficulty centers on the question of whether the taxpayer must recognize gain on the qualifying property surrendered to the full extent of the unqualified property received, or whether all properties received should be considered received for properties surrendered in proportion to the relative fair market values and the gain from receipt of unqualified property be similarly apportioned.

To date, neither the Code, the Regulations nor any Revenue Rulings address themselves specifically to the problem. The only court to encounter the problem did not give a very thorough or satisfactory analysis. In *Sayre v. United States*,[112] the taxpayer

110. Rev. Rul. 59-229, 1959-2 C.B. 180.
111. G.C.M. 2641, VI-2 C.B. 16.
111a. TREAS. REG. § 1.1031(d)-2, Example 2(c).
112. 163 F. Supp. 495 (S.D.W. Va. 1958).

exchanged a farm and principal residence, for another farm and $15,200 cash. The farm and residence exchanged had a combined market value of $90,200 and a tax basis of $45,000. The principal residence had a market value of $9,000. The farm received had a market value of $75,000.

The Service proposed to apportion the unqualified property received in proportion to the fair market values of the properties transferred. Accordingly, the Service suggested that since the old residence represented $9,000 of the $90,200 collective market value of the house and farm exchanged, only 90/902 of the $15,200 (unqualified property) or $1,516.63 was paid for the residence. The Service then suggested that 90/902 of the $75,000 market value of the farm received, or $7,483.37 was paid for the residence. Under this theory, since no basis was shown for the old residence, a total of $22,683.37 would be recognizable gain from the exchange. That figure represents the $1,516.63 of the unqualified property received attributable to the principal residence, the balance of the $15,200 cash received, or $13,683.37, and the $7,483.37 worth of the $75,000 farm received that was deemed attributable to the principal residence transferred.

The taxpayer asserted that the $9,000 reinvested in a principal residence should be subtracted from the $15,200 of unqualified property received and only the remainder subjected to tax.

To support its position, the Service offered two examples to illustrate the "injustice" of the taxpayer's position:

> Assume that a farm having a market value of $80,000 and a basis of $40,000, along with a residence thereon having a market value of $20,000 and a basis of either $10,000 or $5,000, are exchanged by Taxpayer X for a farm worth $85,000 and $15,000 cash "boot." Using the Government's theory of fractional designation that the residence was worth $20,000 of the total $100,000 received, so that the house was exchanged for 1/5 of the "boot" and 1/5 of the new farm, the Government states that the taxable gain from the transaction would be $22,000 if the basis of the residence were $10,000 and the taxable gain would be $27,000 if the basis of the residence were $5,000. Defendant claims that under the taxpayer's theory of apportionment, the recognized gain in either instance would be $15,000. This, it is urged, could not be correct because of the difference in basis in the two problems.[113]

In fact, the court held that the result under the taxpayer's theory was correct. It stated that the intent of the statute was

113. *Id.* at 498.

to cause recognition only of actual economic gain, *i.e.*, in the examples, $15,000 of cash received. In dicussing principles of the Code provisions as they relate to this type of transaction the court stated:

> Unlike the usual general rule in income tax matters that all income is recognized and taxed at the time of realization, here we are dealing with two exceptions which Congress has seen fit to include in the tax structure: (1) nonrecognition of gain upon the exchange of like properties held for productive use, and (2) the exchange of principal residences (including sale of one and purchase of another). In both of these situations, relief has been granted to taxpayers because Congress has felt it would be inequitable to impose a tax where there has been no real economic gain.[114]

The phrase, "real economic gain" as used by the court apparently means the lesser of the gain realized or the value of the unqualified property received. It is interesting to note that at the other extreme of the "allocation formula" approach, some portion of the unqualified property received may go unrecognized even though there was sufficient gain realized to cover it. Consider the following example: Taxpayer transfers, in a section 1031 exchange, two parcels of real estate, one with a market value of $10,000 and a tax basis of $4,000 and one with a market value of $10,000 and a tax basis of $8,500 in exchange for a rental property with a market value of $15,000 and $5,000 cash. Taxpayer has realized $7,500 of gain and has received unqualified property in the amount of $5,000. If the unqualified property is deemed to have been received in exchange for properties surrendered and allocated accordingly, $2,500 will be allocated to each farm transferred. If $2,500 is allocated to the second farm and if gain may be recognized only to the extent of gain realized, $1,000 of the $2,500 will go unrecognized notwithstanding the fact that, taking the transaction as a whole, there was more than sufficient gain to cover the amount of unqualified property received.

As noted by the court in *Sayre* and by many courts preceding it, the purpose of section 1031 is to permit a taxpayer to defer recognition of gain when in an economic and practical sense his ownership of qualified property has undergone a change in form rather than substance. The purpose of the provision is defeated if, as the Service recommended in *Sayre,* he is required to recognize gain that he has not in an economical and practical sense received or if, as illustrated by the examples above, he is permitted to realize gain in an economical and practical sense without recognizing it at the time of the transfer. The simplest approach to the problem would be to allocate all unqualified property received to qualified property transferred. However, it is apparent that as of this writing the Service is not disposed to follow that course, and it may be assumed

114. *Id.* at 497.

that a taxpayer will allocate in a manner that will provide him the greatest tax benefit. As so frequently happens in the tax field, in the absence of some legislative or administrative guidance, a set of rules most likely will be developed from such a hodge-podge of compromises that the best legal mind will be at a loss to understand and apply them.

5. *Installment Reporting of Gain Recognized*

If a taxpayer engages in an exchange to which section 1031(a) is applicable and receives unqualified property to which section 1031(b) is applicable and if the unqualified property is to be received in installments, the taxpayer may choose to report the gain he is required to recognize on the installment basis if the transaction is otherwise qualified.[115] To qualify for installment reporting, payments received in the year of the exchange, exclusive of evidences of indebtedness of the transferee, may not exceed thirty per cent of the selling price.[116] In determining whether payments received in the year of the exchange exceed thirty per cent of the selling price, the market value of the qualified property and all other property received in the exchange must be considered a part of the initial payment.[117]

C. *Loss from Exchanges Not Solely in Kind*

As stated in the preceding discussion, any loss realized on the transfer of unqualified property as part of an otherwise qualified exchange may be recognized by the taxpayer. However, section 1031(c) provides that a loss shall not be recognized from an exchange to which section 1031(a) is applicable where, in addition to qualified property, unqualified property is received.[118]

D. *Basis of Property Received in a Section 1031 Exchange*

1. *Basic Rule*

As is generally the case with all nontaxable exchanges of property in an exchange to which section 1031(a) is applicable, the adjusted basis of property transferred is carried over and becomes the basis of the property received by the taxpayer.[119] This, of

115. Rev. Rul. 65-155, 1965-1 C.B. 356.
116. INT. REV. CODE of 1954, § 453.
117. Rev. Rul. 65-155; Sayre v. United States, 163 F. Supp. 495, 497 (S.D.W. Va. 1958).
118. Treas. Reg. § 1.1031(c)-1, T.D. 6935, 1967-2 C.B. 272.
119. INT. REV. CODE of 1954, § 1031(d); Treas. Reg. § 1.1031(d)-1(a), T.D. 6935, 1967-2 C.B. 272.

course, is the key to allowing the deferral of the recognition of gain without relieving the taxpayer of liability for tax. Assuming an arms-length transaction wherein the values of the properties exchanged are equal, the taxpayer's tax liability is not changed by the transaction.

To the extent money is transferred or received as a part of the exchange, the transaction is in effect a partial purchase or sale and the basis of the property received by the taxpayer is adjusted accordingly. Thus, if a taxpayer transfers qualified property plus money in exchange for qualified property, his basis for the qualified property received is his adjusted basis for the qualified property transferred increased by the money transferred.[120] If the taxpayer transfers qualified property in exchange for qualified property plus money, his basis in the qualified property transferred is decreased by the money received and increased by the amount of gain recognized.[121] In this regard, the transfer or exchange of liabilities is considered a transfer or exchange of money. The fact that in an exchange of liabilities and certain other property the taxpayer may offset liabilities transferred against liabilities received to determine net gain to be recognized is irrelevant to a determination of basis for property received in a qualified exchange.

2. *Effect of Transferring Unqualified Property*

If a taxpayer transfers qualified property and other property not permitted to be transferred without the recognition of gain or loss, and gain or loss is recognized under section 1002 of the Code, the basis of the property received will be the adjusted basis of all the property transferred increased by the amount of gain or decreased by the amount of loss recognized on the transfer of the unqualified property. For purposes of this provision, in determining the amount of the gain or loss to be recognized, the taxpayer is deemed to have received in exchange for the unqualified property an amount equal to its fair market value on the date of the exchange.[122] This is the only instance in which the realization of loss in a section 1031 exchange will affect basis.[123] Where a taxpayer receives or transfers a property used or to be used for both a qualifying and a nonqualifying use, a proportionate part of the property should be considered as unqualified property.[124]

3. *Effect of Receiving Unqualified Property*

In accord with the basic rule, if a taxpayer recognized gain

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120. INT. REV. CODE of 1954, § 1031(d); Treas. Reg. § 1.1031(d)-1(a), T.D. 6935, 1967-2 C.B. 272.
121. INT. REV. CODE of 1954, § 1031(d); Treas. Reg. § 1.1031(d)-1(b), T.D. 6935, 1967-2 C.B. 272.
122. Treas. Reg. § 1.1031(d)-1(e), T.D. 6935, 1967-2 C.B. 272.
123. Treas. Reg. § 1.1031(d)-1(d), T.D. 6935, 1967-2 C.B. 272.
124. Sharp v. United States, 199 F. Supp. 743 (D. Del. 1961).

under section 1031(b) because of the receipt of unqualified property, the basis of all the properties received is the adjusted basis of the property transferred decreased by the amount of any money *received* and *increased* by the amount of any gain recognized.[125] In this regard, expenses paid in effecting the exchange, such as brokerage commissions, will increase the taxpayer's basis.[126]

4. *Allocation of Basis Among Properties Received*

As indicated above, the transfer of several properties in a section 1031 exchange gives rise to very little difficulty relative to the transferor's basis in the property received. To the extent his records establish the adjusted basis of each of the properties at the time of the transfer, he simply adds them all together, adjusts the total for any gain or loss recognized in their transfer, and the result is his basis for the property received. However, when a taxpayer receives several properties in an exchange, his basis problems are significantly more complicated. He must allocate his basis among the several properties (other than money or liabilities) received.

a. *Allocation Among Qualified Properties*

When a taxpayer receives several qualified properties in a qualified exchange, he must allocate his basis among the several properties in accordance with their respective fair market values on the date of the exchange.[127] To illustrate the principle, assume that a taxpayer transfers improved real estate with a basis of $110,000 of which $100,000 is attributable to land and $10,000 to a building. He receives in exchange two properties, lot 1 valued at $100,000 with $20,000 attributable to land and $80,000 to a building, and lot 2 valued at $150,000 with $30,000 attributed to land and $120,000 attributed to a building. The total consideration received is $250,000. Therefore, the allocation of basis to each lot is as follows:

Lot #1

$$\frac{\$100{,}000}{\$250{,}000} \times \$110{,}000 = \$44{,}000$$

Lot #2

$$\frac{\$150{,}000}{\$250{,}000} \times \$110{,}000 = \$66{,}000$$

These figures represent the total allocation of the taxpayer's basis to the respective lots. The same allocation formula is then used to allocate the basis for each lot between the land and the building on each. Thus, $8,000 is allocated to the land and $35,200 to

125. Treas. Reg. § 1.1031(d)-1(b) & (c), T.D. 6935, 1967-2 C.B. 272.
126. Rev. Rul. 72-456. *See* note 101 *supra*.
127. Rev. Rul. 68-36, 1968-1 C.B. 357.

the building on lot #1 and $13,000 is allocated to the land and $52,800 is allocated to the building on lot #2.[128]

It is interesting to note that the taxpayer has converted a $100,000 nondepreciable asset and a $10,000 depreciable asset into $20,000 of nondepreciable assets and $88,000 of depreciable assets, a net gain of $78,000 in depreciable assets. On the other hand, the other party to this exchange will have lost a significant amount of depreciation deductions to which he might otherwise have been entitled if he had retained the buildings. It may be assumed that neither the Code nor the Regulations intend such a transformation. However, no proposal has been forthcoming from either the Congress or the Service for altering the result. It may be appropriate for the parties to this type of exchange to take these consequences into consideration when valuing the respective properties to be transferred. However, it is arguable that a value based on such a consideration could give rise to a type of unqualified property.

b. *Allocation Among Unqualified Properties*

When, in addition to qualified property, a taxpayer receives unqualified property (other than money or liabilities), there is a significant variation from the above principle. For purposes of allocation, there is first assigned to the unqualified property (other than money or liabilities) an amount of basis equal to its fair market value on the date of the exchange. The remainder of the taxpayer's basis is then allocated to the qualified property in accordance with the above formula.

c. *Business Exchanges*

There is no authoritative discussion of the application of the above allocation rules to an exchange of complete businesses. However, such exchanges have been approved by the Service[129] and it is logical to assume that the above rules will be utilized as applicable to apportion basis among the various classes of property received and then among the various items of property within each class.

E. *Holding Period of Property Received in a Section 1031 Exchange*

In determining the holding period of property received in a section 1031 exchange, the holding period of the transferred property may be tacked on to the holding period of the acquired property if the transferred property is a capital asset, as that term is defined in section 1221 of the Code, or a section 1231 asset and if the basis

128. *Id.*
129. Rev. Rul. 59-229, *supra* note 86; Rev. Rul. 72-456, *supra* note 101.

of the acquired property has the same basis in whole or in part, as the basis of the property transferred.[130] If the property transferred does not qualify under this description, the holding period of the acquired property will begin on the date of the exchange.

Serious questions arise as to the application of this rule to unqualified property received in an exchange since such property acquires a basis by reference to its fair market value at the time of the exchange. It would appear that such a reference for determination of basis would be sufficient to eliminate such property from the tacking benefits of Code section 1223. Of equal concern is the application of the rule to multiple asset exchanges. While some allocation formula, such as that used to allocate basis, would seem appropriate, the utilization of such a formula, especially to complete business exchanges, will be exceedingly complex, if not impractical.

Such problems, however, should be quite rare. The holding period is significant only to the extent that capital gains treatment on a disposition of property depends on whether the asset was held for six months or more, and any disposition of property received in a section 1031 exchange within six months of the date of the exchange is to be discouraged. Such a prompt disposition may cause the Service to assert that the property was acquired for sale rather than for productive use in a trade or business or for investment.

III. Application of Depreciation Recapture Rules to Section 1031 Exchanges

Among the assets qualified for section 1031 treatment are those held for productive use in a trade or business. By definition, these same assets should be qualified for depreciation deductions under section 167 of the Code, which provides that there shall be allowed as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income. To the extent property on which depreciation deductions have been taken is a part of an exchange to which section 1031 is applicable, reference to the depreciation recapture provisions of the Code is appropriate. Pursuant to the provisions of sections 1245 and 1250 of the Code, upon the sale, exchange or other disposition of property subject to depreciation deductions, a taxpayer may be required to recognize as ordinary income some or all of the depreciation previously deducted.

130. INT. REV. CODE of 1954, § 1223(1).

A. *Application of Section 1245*

1. *General Statutory Scheme*

Section 1245 is generally applicable to depreciable personal property and certain depreciable, tangible real property described in section 1245(a).[131] The types of tangible real property to which section 1245 applies are: real property used as an integral part of manufacturing, production or extraction, or for furnishing transportation, communications, electrical energy, gas or sewerage disposal services; research facilities or bulk storage facilities used in connection with any of the foregoing; and elevators and escalators, and certain property subject to amortization deductions under sections 169, 185 and 188 of the Code. It does not include buildings or their structural components.

When a taxpayer disposes of such property, he must recognize ordinary income to the extent of the lesser of depreciation taken since January 1, 1962 or the gain realized.[132] However, certain exceptions are made to this general rule in transactions to which section 1031 is applicable.[133]

2. *Limitations on Applicability in Section 1031 Exchanges*

If section 1245 property is transferred in an exchange to which section 1031 is applicable, the section 1245 gain is limited to the gain recognized in the exchange plus the fair market value of non-section 1245 property acquired which is not included in the gain recognized, *i.e.*, the fair market value of non-section 1245 property acquired which is qualified section 1031 property.[134] Accordingly, if the exchange is solely for like-kind property, there would be no recognition of gain under section 1245.[135] If gain is recognized because unqualified property is received, ordinary income is recognized to the extent attributable to section 1245 property.[136]

3. *Multiple Asset Exchanges*

If both section 1245 and non-section 1245 property are exchanged for section 1245 and non-section 1245 property, the total amount realized is allocated between the section 1245 and non-section 1245 property transferred in proportion to their respective fair

131. *Id.* § 1245(a)(3).
132. *Id.* § 1245(a)(1).
133. *Id.* § 1245(b)(4).
134. *Id.*; Treas. Reg. § 1.1245-4(d)(1), T.D. 7207, 1972-2 C.B. 106.
135. Treas. Reg. § 1.1245-4(d)(2), Example (1), T.D. 7207, 1972-2 C.B. 106.
136. INT. REV. CODE of 1954, § 1245(b)(4); Treas. Reg. § 1.1245-4(d)(1), T.D. 7207, 1972-2 C.B. 106; Treas. Reg. § 1.1245-4(d)(2), Example (2), T.D. 7207, 1972-2 C.B. 106.

market values.[137] For purposes of this provision, the amount realized on the transfer of section 1245 property is deemed to consist of so much of the fair market value of the section 1245 property acquired as does not exceed the amount realized from the 1245 property transferred. The remaining portion of the amount realized on the transfer of the section 1245 property is deemed to consist of so much of the fair market value of the non-section 1245 property acquired as does not exceed such remaining amount. The amount realized upon the disposition of the non-section 1245 property is deemed to be the fair market value of the property acquired which is not taken into account in determining the amount realized on the transfer of section 1245 property.[138]

4. *Effect on Basis*

The rules of section 1031(d) are applicable to determine basis in an exchange involving section 1245 property.[139] Where section 1245 property is transferred in a qualified exchange for both section 1245 and non-section 1245 property, basis is allocated first to the non-section 1245 property received to the extent of its fair market value, and the remainder to the 1245 property received.[140] The non-section 1245 property is treated essentially the same as unqualified property under section 1031.

B. *Application of Section 1250*

1. *General Statutory Scheme*

Section 1250 is applicable to any real property (other than section 1245 property) which is or has been subject to the allowance for depreciation provided by section 167 of the Code.[141] Section 1250 property includes *intangible* real property such as leases and *tangible* real property such as buildings and their structural components, except elevators and escalators. However, tangible real property of a nature described in section 1245 is not included.[142] In this regard, section 1250 property may lose its character and become section 1245 property if it is used in a manner described in section 1245(a)(3). However, section 1245 property can never become section 1250 property.[143]

137. Treas. Reg. § 1.1245-4(d)(4)(i), T.D. 7207, 1972-2 C.B. 106.
138. Treas. Reg. § 1.1245-4(d)(4)(ii), (iii), T.D. 7207, 1972-2 C.B. 106.
139. Treas. Reg. § 1.1245-5(a)(1), T.D. 7207, 1972-2 C.B. 106.
140. Treas. Reg. § 1.1245-5(a)(2), Example, T.D. 6832, 1965-2 C.B. 292.
141. INT. REV. CODE of 1954, § 1250(c).
142. Treas. Reg. § 1.1250-1(e), T.D. 7193, 1972-2 C.B. 489.
143. Treas. Reg. § 1.1250-1(e)(4), T.C. 7193, 1972-2 C.B. 489.

When a taxpayer disposes of section 1250 property, he must recognize ordinary income to the extent of the applicable percentage of the lower of the depreciation taken which is in excess of straight line depreciation, or the gain realized.[144] However, as is the case with section 1245, certain exceptions are made to this general rule in transactions to which section 1031 is applicable.[145]

2. *Limitations on Applicability in Section 1031 Exchanges*

If section 1250 property is transferred in an exchange to which section 1031 is applicable, the section 1250 gain is limited to the greater of the amount of gain recognized under section 1031, without reference to section 1250, or the excess of the amount of gain which would, but for section 1250(d)(4), be recognized under section 1250(a) over the fair market value of section 1250 property acquired.[146] An important distinction should be noted between the language here and the language of section 1245. Under section 1245, gain will be recognized if the market value of the 1245 property transferred exceeds the market value of the 1245 property received. In section 1250, gain will not be recognized as long as the value of the section 1250 property received is not less than the section 1250 gain that would otherwise be recognized under 1250(a).

If gain is recognized in a section 1031 exchange because unqualified property is received, the recognition of section 1250 gain cannot exceed the greater of the gain recognized because of the unqualified property or the excess of the amount of gain which would, but for section 1250(d)(4), be recognized under section 1250(a) over the fair market value of section 1250 property received.[147]

3. *Multiple Asset Exchanges*

If both section 1250 property and non-section 1250 property are transferred in a qualified exchange, the total amount realized is allocated between the classes of property in proportion to their respective fair market values.[148] The amount realized on the transfer of a class shall be so much of the fair market value of the qualified property of the same class received which is not in excess of the amount realized from the class transferred.[149] The remaining amount from the class shall be so much of the fair market value of any other property received which is not in excess of the remaining portion.[150] For purposes of this provision, the fair market value of property received is taken into account only once.[151]

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144. INT. REV. CODE of 1954, § 1250(a)(1).
145. *Id.* § 1250(d)(4).
146. *Id.*
147. *Id.*
148. Treas. Reg. § 1.1250-3(d)(6)(ii)(a), T.D. 7193, 1972-2 C.B. 489.
149. Treas. Reg. § 1.1250-3(d)(6)(ii)(b), T.D. 7193, 1972-2 C.B. 489.
150. Treas. Reg. § 1.1250-3(d)(6)(ii)(c), T.D. 7193, 1972-2 C.B. 489.
151. Treas. Reg. § 1.1250-3(d)(6)(ii)(d), T.D. 7193, 1972-2 C.B. 489.

4. *Effect on Basis*

If section 1250 property is transferred in a qualified exchange, and by reason of section 1250(d)(4) all or part of the section 1250 gain *realized* is not *recognized*, the total basis of the qualified property acquired, including section 1250 property, is determined under section 1031(d).[152] If more than one item of section 1250 property is received in a qualified exchange, basis is allocated among the items in proportion to their relative fair market values.[153] If the qualified property acquired consists of both section 1250 property and non-section 1250 property, basis is allocated between the two classes of property in proportion to their relative fair market values.[154] For purposes of this provision, the market value of the section 1250 property is the excess of the property's fair market value over the section 1250 gain not recognized pursuant to section 1250 (d)(4).[155]

5. *Additional Depreciation on Subsequent Sale of Section 1250 Property Received in a Qualified Exchange*

The amount of any section 1250 gain not recognized in a qualified exchange by reason of section 1250(d)(4)(A) is carried over to the section 1250 property acquired.[156] If several items of section 1250 property are acquired, this additional depreciation is allocated to the items in proportion to their respective adjusted bases.[157]

C. *Installment Reporting*

Any gain required to be recognized under either of the recapture provisions may be reported under the installment provisions of section 453 of the Code, if the transaction is otherwise qualified for installment reporting. However, if the installment method is used, the income, other than interest, on each installment payment is deemed to consist of gain to which the recapture provisions apply, until all such gain has been reported. The remainder is then allocated to income to which the recapture provisions do not apply.[158]

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152. Treas. Reg. § 1.1250-3(d)(4)(i), T.D. 7193, 1972-2 C.B. 489.
153. Treas. Reg. § 1.1250-3(d)(4)(ii), T.D. 7193, 1972-2 C.B. 489; *Id.* § 1.1250-3(d)(2)(iv).
154. Treas. Reg. § 1.1250-3(d)(4)(ii), T.D. 7193, 1972-2 C.B. 489; *Id.* § 1.1250-3(d)(2)(iii).
155. Treas. Reg. § 1.1250-3(d)(4)(ii), T.D. 7193, 1972-2 C.B. 489; *Id.* § 1.1250-3(d)(2)(iii).
156. Treas. Reg. § 1.1250-3(d)(5)(i), T.D. 7193, 1972-2 C.B. 489.
157. *Id.* § 1.1250-3(d)(5)(ii).
158. Treas. Reg. § 1.1245-6(d), T.D. 7084, 1971-1 C.B. 230; *Id.* § 1.1250-1(c)(6), T.D. 7193, 1972-2 C.B. 489.

D. *Summary of Recapture Effects*

It should be noted that where the recapture provisions are applicable to a transfer to which section 1031 applies, nonrecognition of gain will not depend solely on the tests of section 1031. Gain may be recognized even if the exchange is fully qualified under section 1031 if the section 1245 or 1250 property is exchanged for property not all of which is section 1245 or 1250 property. Thus, an exchange of property held for productive use in a trade or business or improved property for unimproved property may require recognition of gain notwithstanding the nonrecognition provisions of section 1031. In addition, since unrecaptured gain is carried over, the taxpayer will be required to keep detailed records of the carryover and the property to which it is applicable. He should also be careful to recall that property acquired as section 1250 property may change its character under certain circumstances resulting in a change of the applicable recapture provisions.

IV. MULTIPLE-PARTY EXCHANGES

Although a party to a real estate transaction may desire to exchange rather than sell his property, he will seldom be so lucky as to be dealing with a purchaser who is willing to exchange properties, or who has suitable qualified property readily available to exchange. In this situation, the party may find that a multiple-party exchange can resolve the problem. The objectives of both parties often can be satisfied by the introduction of another party who has suitable qualified property which he is willing to sell or exchange. This concept was approved by the Service in Revenue Ruling 57-244.[159] In that instance three taxpayers acquired a tract of land which they then divided into three separate lots. Subsequently, they agreed to exchange lots with any difference in acreage to be purchased with cash. Accordingly, C acquired the lot owned by B, B acquired the lot owned by A and A acquired the lot owned by C. After the exchange, A sold the lot he acquired from C to another individual. The Service held that the transaction was a qualified exchange under section 1031 and that gain would only be recognized to the extent of cash received.

Such utilization of the nonrecognition provisions of section 1031 has served to make the section a much more viable tax planning tool in recent years. However, the zeal of taxpayers seeking the benefits of the provision and their reckless indifference to the statutory provisions have served to illustrate certain problem areas that should be considered when contemplating a section 1031 exchange.

A. *Exchange After Entering into a Sales Agreement*

In some instances, the taxpayer enters into a sales agreement

159. Rev. Rul. 57-244, 1957-2 C.B. 247.

before he is aware of the nonrecognition benefits of section 1031. Efforts to reform the transaction to quality for a section 1031 exchange at that point should be carefully planned. Strict observance of the statute and regulations should be attempted.

In *Leslie Q. Coupe*,[160] the taxpayers had agreed to sell their farm to a railroad. Later the taxpayers were advised of the benefits available to them in a section 1031 exchange. The taxpayers promptly located suitable property for an exchange but the railroad refused to take title to the property located. It did, however, agree to allow the taxpayer to exchange properties and to purchase the farm from the new owners. Taxpayer's attorney and another attorney purchased the property to be exchanged, exchanged it for taxpayer's farm and then sold the farm to the railroad. The Service contended that the attorneys were acting as agents of the taxpayer and therefore that equitable title to the exchange property was vested in the taxpayer as a result of its purchase by his attorney. The Tax Court held that the attorneys were acting as agents for an undisclosed principal, and that the undisclosed principal purchased the property. Consequently, a qualified exchange was effected.

A similar result was effected in the earlier case of *Alderson v. Commissioner*.[161] In *Alderson*, the taxpayers had entered into a sales agreement and a deposit on the sales price was placed in escrow. Several months later, the taxpayer located suitable exchange property. The sales contract was then amended to require the original purchaser, through an escrow agent, to purchase the exchange property and exchange it for taxpayer's property. The Service contended that the transaction was in substance a sale and purchase transaction, but the Ninth Circuit Court of Appeals held that the transaction was in substance a qualifying exchange. A key to this decision, apparently, was the fact that the taxpayer had wanted to exchange his property but had not been able to find suitable exchange property.

B. *Effect of Agreements Providing for Sale or Exchange*

In some instances, the taxpayer may have a purchaser willing to cooperate in an exchange transaction but not willing to wait for any length of time for the taxpayer to find suitable exchange property. The taxpayer's response to these situations has been to execute a contract to sell his property for cash if an exchange property

160. 52 T.C. 394 (1969), *acquiesced in*, 1970-2 C.B. XIX.
161. 317 F.2d 790 (9th Cir. 1963).

has not been located within a stipulated period of time. If suitable property is subsequently located, the courts have permitted an exchange where the transaction otherwise qualifies. This was the fact situation in *Merchantile Trust Company of Baltimore.*[162] The Service disallowed section 1031 treatment contending that in substance the transaction was a sale. The court held to the contrary, finding that the taxpayer had intended to exchange the property if he could and that the parties did in fact exchange properties. It refused to ignore the "real transactions."

C. *Extent to Which Parties May Be Involved in Engineering an Exchange*

As is obvious from the above, the acquisition of property solely for the purpose of effecting a nonrecognition exchange is no bar to the benefits of section 1031. In fact, most of the exchange transactions are engineered to qualify the exchange, and the taxpayer is usually the engineer. The extent to which a taxpayer can involve himself in creating a qualified exchange without affecting the validity of the exchange has been the subject of several court decisions.

In *J.H. Baird Publishing Co.*,[163] a purchaser repeatedly tried to buy taxpayer's property, but because he faced a large capital gains tax on the sale, the taxpayer refused to sell. A realty company proposed to resolve the conflict by purchasing land and erecting a building suitable to taxpayer's needs which it then would exchange for taxpayer's property. Accordingly, taxpayer executed an agreement with the realty company by which taxpayer deeded his property to the realty company subject to a right to use the property until the realty company acquired a new lot and erected the new building. The realty company promptly sold taxpayer's property, subject to the use, to the purchaser. It held the money received as escrow agent for taxpayer. The realty company then used this money to acquire the new property and erect the required building. The taxpayer stipulated the building specifications and his signature was necessary to withdraw the money. The Service contended that the realty company had acted as taxpayer's agent and disallowed the exchange. The Tax Court disagreed. It found that the realty company had acted as a principal, not as an agent. The court emphasized the fact that the realty company had paid taxes on the new property with its own funds and that the taxpayer had always intended to effect an exchange. The realty company had also taken title to the property in its own name.

In a similar situation, *Coastal Terminals, Inc. v. United States*,[164] the taxpayer obtained an option to purchase certain prop-

162. 32 B.T.A. 82 (1935).
163. 39 T.C. 608 (1962), *acquiesced in*, 1963-2 C.B. 4.
164. 320 F.2d 333 (4th Cir. 1963).

erty on which it proposed to erect new facilities. Taxpayer assigned the option to a prospective purchaser of its old property. The prospective purchaser then exercised the option, purchased the properties, erected the required facilities and exchanged the new property for taxpayer's old property. It was held that a valid exchange had been effected.

In *Mays v. Campbell*,[165] the taxpayer agreed to transfer Texas property and cash to a foundation in exchange for New Mexico property owned by the foundation. The exchange was contingent on the foundation's finding a buyer for the Texas property. On the same day that the contract for the exchange was executed, the foundation executed an agreement to sell the Texas property to a corporation owned forty per cent by the taxpayer, ten per cent by his attorney and twenty-five per cent by the taxpayer's adult sons. The Service disallowed an exchange on the basis that the corporation had merely acted as a conduit for the exchange. The court found that the corporation had not been organized as a conduit for the exchange but had been an active, substantial corporation for ten years and had invested its own money. Absent any evidence of a sale between the taxpayer and the corporation, the court held that a qualified exchange had taken place.

In conclusion, it is apparent from the above that two factors stand apart from all others in validating an exchange: (1) the taxpayer's intent; and (2) strict procedural compliance with the mechanics of an exchange. In this regard reference should be made to *Carlton v. United States*.[166] In *Carlton*, the taxpayer contracted with a corporation whereby the corporation was given an option to purchase the taxpayer's property. The contract was conditioned on the corporation purchasing other property and entering into a tax-free exchange for the taxpayer's property. The corporation obtained a contract to purchase the desired exchange properties and transferred the contract to the taxpayer. The taxpayer transferred its deed to the corporation for cash which was then used to purchase the properties under the contract transferred to it by the corporation. The court disallowed a tax-free exchange, holding that the taxpayer had failed to perfect the form of the transaction. Noting that the intention of the parties is not controlling, the court stated, "what was actually done is determinative of the tax treatment."[167]

165. 246 F. Supp. 375 (N.D. Tex. 1965).
166. 255 F. Supp. 812 (S.D. Fla. 1966), *aff'd*, 385 F.2d 238 (5th Cir. 1967).
167. *Id.* at 243.

V. Conclusion

As can be seen from the foregoing, an exchange to which section 1031 is applicable can be a very useful tax planning tool. To the extent a taxpayer holds high value-low basis property, a substantial tax benefit may be realized by qualifying any disposition of the property for section 1031 treatment. However, it must be remembered that tax is not avoided under section 1031, but is merely deferred. Nonetheless, an astute real estate investor may be able to so utilize the provisions as to substantially increase his investment without the payment of tax. By exchanging property for more valuable property and mortgaging the difference between his original equity and the market value of the acquired property, an investor may be able, in essence, to play the market unhampered by taxation.

As new types of investment occur, the opportunities to utilize section 1031 to advantage are more prevalent. The recent interest in multiple-party exchanges has added a whole new concept and potential to the utilization of section 1031 in tax planning. It is evident that a favorable judicial climate permits a broad flexibility in the use of section 1031 in three-party exchanges. While the limits of a taxpayer's involvement in creating a qualified exchange are not clearly defined, it is obvious that there may be substantial involvement. However, the courts have generally insisted on complete compliance with the mechanics of a qualified exchange. While they have universally professed great concern with the intention of the parties, where the mechanics have been lacking, the intention of the parties has not sufficed to qualify the exchange.

Nevertheless the courts have not hesitated to look to the substance rather than form of a transaction to find an exchange rather than a sale in the sale and lease-back transactions. It is submitted, however, that even here, rigid fulfillment of the qualified exchange requirements would alleviate many of the difficulties in this area. The courts have generally not concerned themselves with taxpayer motives in effecting an exchange.

In all events, the controlling criteria to effecting a valid exchange seems to be the taxpayer's compliance with the mechanics of a qualified exchange. While other factors may be important this one factor is critical. This point was appropriately emphasized by the court in *Carlton* when, in holding that an exchange had not qualified, it stated:

> Considering how close the appellants came to satisfying the requirements of that section and the stipulation that an exchange was intended, this result is obviously harsh. But there is no equity in tax law, *Henderson Clay Products*, [324 F.2d 7, (GA-5 1962)], and such must the result be if the limitation in Section 1031 to exchanges is to have any meaning.[168]

168. *Id.*

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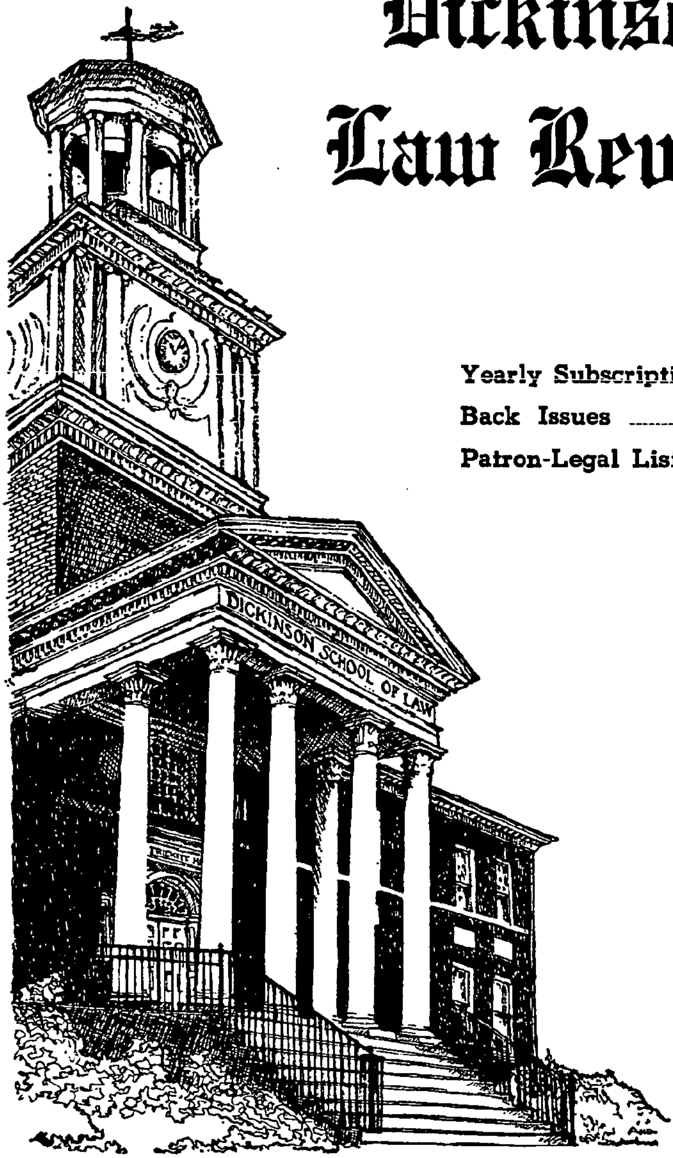

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